

CC:IT&A:TR-45-949-91

Br2:PSKirwan

JUL 19 1991

Regional Director of Appeals
Mid-Atlantic Region

Assistant Chief Counsel(Income Tax and Accounting)

Technical Coordination Report 17,897, Submitted by Ms. Irma
Rosendahl, Washington District Appeals Office

Ms. Rosendahl in her report suggested that the Service issue a revenue ruling clarifying the proper treatment of attorney fees paid by an individual who has received an award of damages that is includible in that individual's gross income. Specifically, she suggested that the effect of section 67 of the Code on the treatment of attorney fees was not widely recognized and should be publicized in a revenue ruling.

Before addressing the substance of the suggestion in TCR 17,897, we wish to clarify several matters raised in the TCR. The TCR states that the 1989 amendment to section 104(a) provides "that punitive damages received after July 10, 1989, may no longer be excluded from gross income unless there is also physical injury." (Emphasis added.) This sentence raises two problems. First, the sentence implies that punitive damages were excludible from gross income prior to the 1989 amendment. We disagree. Punitive damages have always been taxable. See, e.g., Rev. Rul. 84-108, 1984-2 C.B. 32; Commissioner v. Glenshaw Glass, 348 U.S. 426 (1955); Miller v. Commissioner, 914 F.2d 588 (4th Cir. 1990), rev'g, 93 TC 330 (1989).¹ Thus, in our view, punitive damages were not excludible under section 104(a)(2) even before the 1989 amendment.

The second problem raised by the above-quoted sentence is the implication that punitive damages awarded in a case involving physical injury are excludible from gross income. The 1989 amendment to section 104(a) provides that "[p]aragraph (2) shall not apply to any punitive damages in connection with a case not

¹ The 1989 amendment to section 104(a)(2) had no application to Miller because of a later effective date. If it had applied, the damages would clearly have been taxable because the award was for defamation, a non-physical injury. The court mentions the amendment in a footnote, merely stating that the Government conceded it was inapplicable.

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involving physical injury or physical sickness." This portion of section 104(a) was added by section 7641(a) of the Revenue Reconciliation Act of 1989, Pub. L. 101-239, 1990-1 C.B. 210, 255. While an argument can be made that this language raises an inference that punitive damages are excludible when awarded in connection with a case that does involve physical injuries or sickness, we do not believe that the matter is free from doubt. Before any cases are conceded on the basis of this inference, we recommend that you seek technical advice from this office so that a full consideration of the issue may be undertaken.

We shall now turn to the substance of the TCR. Ms. Rosendahl recommended that a revenue ruling be published clarifying the effect of section 67 on the treatment of attorney fees by an individual who has received an award of damages includible in gross income. We do not believe that such a revenue ruling is necessary. In Rev. Rul. 87-102, 1987-2 C.B. 78, the Service considered a situation in which the taxpayer received social security disability benefits, a portion of which was includible in the gross income of the recipient. The Service stated:

Under the facts of this case, section 265 of the Code and the regulations thereunder require that the amount of the legal fees expended by A for the collection of income and otherwise deductible by A under section 212 in 1987 be allocated between the taxable and tax-exempt income, because only one-half of the social security disability benefits received by A in 1987 is includible in A's gross income. The one-half that remains deductible under section 212 is then added to A's other miscellaneous itemized deductions, and the aggregate amount of those deductions in excess of 2 percent of A's adjusted gross income is deductible pursuant to section 67.

1987-2 C.B. 78, 79. Thus, the Service has already published a revenue ruling containing the legal guidance requested in TCR 17,897. We therefore recommend that no additional revenue ruling projects be opened on this subject.

We appreciate Ms. Rosendahl's interest and initiative in submitting her report. Copies of this memorandum are attached for Ms. Rosendahl and other interested parties. If you have any

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question concerning this matter, please call Patrick S. Kirwan at
FTS 566-6450.

By: (signed) Neal E. Sheldon
Neal E. Sheldon
Senior Technician Reviewer,
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